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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 6/26/84 **Number:** 169022CA **Due By:**

Subject: Cabinet Council on Economic Affairs - June 28, 1984
8:45 a.m. - Roosevelt Room

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
Baker	☑	☐
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
~~Jenkins~~ Chapman	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, June 28, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background papers are attached.

DCI EXEC REG

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson ☐ Don Clarey
☑ Tom Gibson ☐ Larry Herbolsheimer
Associate Director
Office of Cabinet Affairs
456-2800

L-300B

THE WHITE HOUSE

WASHINGTON

June 26, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the June 28 Meeting

The agenda and papers for the June 28 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider three agenda items. The first is the administration position on corporate takeover and tender offer legislation. Four bills have been introduced in the House of the Representatives addressing corporate takeovers and tender offers. Chris DeMuth has prepared a draft letter opposing these recently introduced bills. A copy of the draft letter is attached and will serve as the basis for the discussion of this issue.

The second agenda item is on the U.S. agricultural commodity outlook. Secretary of Agriculture Block requested the opportunity to briefly update Council members on the current agricultural commodity outlook. A brief paper from him on this issue is also attached.

The third agenda item relates to adjustable rate mortgages. There has been considerable attention recently to the possibility of future significant disclosures on adjustable rate mortgages. A paper, prepared by Thomas Healey, Assistant Secretary of the Treasury for Domestic Finance, on "Adjustable Rate Mortgage Default Risk," is also attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

June 28, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Administration Position on Corporate Takeover and Tender Offer Legislation (CM # 481)
2. U.S. Agricultural Commodity Outlook (CM # 482)
3. Adjustable Rate Mortgage Default Risk (CM # 479)

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

DRAFT

Honorable Timothy E. Wirth
Chairman, Subcommittee on Telecommunications,
Consumer Protection and Finance
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On May 22, 1984, four proposed bills addressing corporate takeovers and tender offers were introduced in the House:

- H.R. 5693--"Tender Offer Reform Act of 1984;"
- H.R. 5694--A bill to prohibit acquisition of corporate control except by means of tender offers for all outstanding shares;
- H.R. 5695--A bill to permit shareholders and the Securities and Exchange Commission to seek injunctive relief from harmful tactics by management in corporate takeover situations; and
- H.R. 5696--"Shareholder Communications Act of 1984."

The Administration has reviewed these proposals carefully and has strong objections to the first three. I am writing to express our views in detail.

Corporate takeovers perform several important functions in our economy. First, they provide a means--sometimes the only feasible means--of policing management conduct in widely held public corporations. Second, they help identify undervalued assets and permit shareholders to realize the true value of their investments. Third, they can reallocate capital and corporate assets into higher-valued uses; enable merger partners to generate joint operating efficiencies; and provide companies with access to financial, management, and other resources not otherwise available.

Takeovers are generally good for shareholders of both bidder and target corporations. The best available data indicate that the average takeover that leads to a merger results in an appreciation in the value of the combined enterprise equal to about 10.5% of the initial value of the merged companies. Shareholders of the acquired corporation realize a premium for their shares averaging 38% of the pre-acquisition market price of

the target; acquirors enjoy smaller, but significant, gains. The division of gains between bidder and target shareholders does not differ substantially between mergers effected by tender offers for "any and all shares" and "two-tier" offers (tender offers followed by a merger at a lower price). Partial tender offers that do not result in a merger lead to somewhat smaller, but still substantial, gains. And these figures understate the economic gains of corporate takeovers, since the pre-takeover market prices for corporate securities often include some premiums anticipating possible future acquisitions.

Earlier actions to regulate tender offers appear to have noticeably discouraged takeover attempts by increasing their costs. The number of tender offers declined nearly 10 percent following enactment of the Williams Act in 1968 and its amendment in 1970. The number of offers increased steadily from 1970 until 1979, although they did not surpass the 1968 level until 1977. They dropped off sharply again in 1980, the year in which the SEC proposed another elaborate set of rules governing tender offers. At a minimum, these facts suggest that we should proceed cautiously in adopting new laws that could make takeover attempts even more expensive and burdensome. The Administration believes that no systematic abuses have been identified that would justify further restrictions on takeover activity. To the contrary, in view of the overwhelming evidence that takeover activity produces significant economic benefits, we should be seeking ways to minimize government disincentives to takeover bids and tender offers.

The proposals to prohibit or regulate potentially abusive "defensive" techniques by target corporations (such as those proposed in H.R. 5693 and H.R. 5695) raise a different set of concerns. These techniques all may have legitimate business purposes as well as the potential for abuse. It is often a difficult question of judgment whether a given technique, in a given set of circumstances, is in fact an abuse that protects incumbent management at the expense of shareholders. Under our federal system, we have traditionally relied on State law and market competition to discipline corporate managers who act against the interests of their shareholders. This system of diverse and responsive State law has been highly successful in protecting shareholders and promoting efficiency in corporate management and financial markets. The proposals before your Committee to regulate defensive techniques would greatly expand federal regulation of corporate management, and would constitute a major step towards imposition of a substantive federal corporation law.

We believe the Federal government's appropriate role in overseeing corporate management decisions is limited to situations where a broader national purpose is to be served, or where existing market disciplines are failing to work effectively. We see no such broader national purpose that would justify adoption of federal restrictions on management defenses to takeover bids and tender offers. To the extent that the

market has failed to restrain defensive abuses, we believe such failure results from excessive regulatory restrictions on bidders.

We are, moreover, very skeptical of the ability of the Federal government to foreclose defensive abuses by prohibiting certain classes of conduct. The prohibition of specific actions will channel defensive behavior into other actions, some of which may be even less desirable. The predictable result will be more prohibitions, more federal regulation, and more waste of resources from attempts to evade the regulations.

Many of these proposals seek to redistribute the balance of power and, hence, the economic gains and losses among the participants in takeover actions, with the hope of creating "fairer" outcomes. However, "fairness" in this case is impossible to determine. Even the question of who benefits or should benefit is problematic. Investors can move in and out of any given stock freely or avoid the equity markets entirely. The large, sophisticated investors, who most people would agree are in the best position to benefit from takeover attempts, are largely pension and mutual funds--i.e., pools of funds from the smallest and least sophisticated investors. In addition, it is not known in advance who will be bidders and who will be targets. The shareholders of each may overlap substantially. The biggest risk is that the Federal government, in the name of fairness, will create rules that make everyone--bidders, targets, and managers--worse off.

In summary, we generally oppose proposals to subject tender offers and takeover attempts to further federal regulation because they are likely to discourage actions that are beneficial to both bidder and target shareholders. We also oppose the creation of federal corporation law to regulate "defensive" management behavior. No market failure has been demonstrated to support either case, and the likely outcome of new federal regulation would be wasted resources.

Our specific comments on the four proposed bills follow.

H.R. 5693--"TENDER OFFER REFORM ACT OF 1984"

H.R. 5693, proposed by the Securities and Exchange Commission, would restrict a bidder's acquisition of shares prior to public notification of intent. It would also, for the first time, prohibit or restrict several corporate management practices under federal law--compensation agreements, tender offers for its own stock, new stock issues, and stock repurchases.

Sections 2 and 3 would restrict a bidder's ability to accumulate a large block of shares before declaring its intentions. The provision would reduce from 10 days to a maximum of 2 days the time period between a bidder's accumulation of 5% of the stock of a target corporation and the day of required disclosure. This

requirement would make it more difficult and more expensive for bidders to mount takeover attempts, and would reduce the gains to a successful bidder from any appreciation in the value of target company shares. We do not consider the rapid accumulation of shares in the market to be an abuse. The effect of this proposal is undesirable--a reduction in takeover attempts and tender offers.

Section 5 would restrict defensive techniques by corporate managers. New or amended compensation agreements between a target corporation and its officers and directors would be prohibited during a tender offer. Such a prohibition would be an unprecedented, unnecessary, and unwise intrusion by the Federal government into corporate management. The ability to offer key corporate managers revised compensation proposals can be beneficial to shareholders in at least two ways. First, it may be necessary to induce key managers to remain with the company during periods of high uncertainty about the corporate future. Second, it may be a useful tool to minimize the incentive for corporate managers to engage in defensive tactics which could be far more detrimental to shareholder interests. In both cases, such agreements serve an important purpose--to bind the interests of managers and shareholders at a time when outside "threats" to incumbent managers might otherwise induce them to act contrary to the interests of their shareholders.

The prohibitions on purchases by a target company of its own securities and issues of new securities during a tender offer may likewise be disadvantageous to target company shareholders. Purchases by the target by a self-tender offer may give target shareholders an attractive alternative to a low bid by an outsider. Sales of securities to third parties may help prompt a bidding war. Even if these devices are sometimes abused, prohibiting them altogether may simply redirect ever-resourceful managements into other defensive strategies that are even less desirable. A defensive stock issue at least has the virtue of placing a significant block of shares in the hands of a single owner, who may then have the power and incentive to police the target's management. An alternative to defensive stock issues might be sale of the target's premier assets--its "crown jewels"--at a bargain price, which lacks any such virtue.

Repurchases from a significant shareholder at a premium over market--so-called "greenmail"--presents a more difficult case, but even here the technique clearly has some desirable effects. First, the possibility that shares may be resold to the target in the event of an unsuccessful takeover attempt raises the expected value--and hence the likelihood--of takeover activity. Prohibitions on repurchases may thus deter takeover offers to the disadvantage of all market participants. Second, evidence indicates that even when "greenmail" takes place, shareholders' stock appreciates, perhaps because of the disciplining effect on management. This technique may be abused, but policing it should be a straightforward matter of State corporation law, and we note

that many States have been active in this area. Given the present state of our knowledge, we believe it would be unwise to restrict repurchase transactions under Federal law.

H.R. 5694

H.R. 5694 would require anyone seeking to acquire 10% or more of the voting equity securities of a company to make a tender offer for all outstanding shares of the company or to acquire such shares directly from the issuer. If the bidder had acquired any shares within the previous 12 months, it would require the offer be for cash at least equal to the highest price paid in any such acquisition.

The effects of H.R. 5694 would be pernicious. Shareholders of blocks in excess of 10% would suddenly find the value of their holdings greatly depreciated since they would no longer command a control premium and could not dispose of their holdings in block transactions; nor could they purchase any additional shares for investment reasons without incurring an obligation to make a tender offer. Investment decisions would be distorted and small shareholders would lose the substantial economic benefits of tender offers for less than "any and all shares," as well as the gains from the disciplining effect on managements arising from the existence of large blocks.

In large public corporations, the concept of shareholder ownership would be dealt a severe blow. The bill would solidly entrench incumbent management in perpetual control of our largest corporations because there would be few, if any, bidders with sufficient resources to make offers for all their outstanding shares. Serious proxy contests would be virtually abolished. In addition, the bill would introduce a significant--and economically undesirable--asymmetry because incumbent management would retain the right to issue large blocks to members of the control group or sympathetic hands.

Even in smaller corporations, changes of control would be unduly inhibited. In addition to limiting the market for the company to bidders able to acquire "any and all shares," the requirement that the price offered be equal to the highest price paid in the previous 12 months may make a tender offer impracticable in a falling market.

H.R. 5695

H.R. 5695 would allow the Securities and Exchange Commission or any shareholder to bring suit under federal law to stop management from taking any action relating to a change of control. The burden of proof would be placed on corporate management to demonstrate that the action in question would be both prudent and fair to the corporations' stockholders. A shareholder could be awarded both attorney's fees and "equitable relief."

Although the stated purpose of this proposal is to avoid "harmful defensive tactics by management in corporate takeover situations," it is written so broadly that it would be certain to have substantial unintended adverse effects. At a minimum, it would lead to a dramatic increase in legal actions and consequent delays and wasted resources. In addition, it would unnecessarily preempt the State role in regulating corporations and would be a step towards creating a federal corporation law and changing the role of the SEC from overseeing disclosure and the effectiveness of public securities markets to actual oversight of corporate management. It would overturn hundreds of years of case law. We have seen no evidence to suggest that such a drastic proposal is warranted.

A short list of potential problems which this bill raises will illustrate our concerns:

- The bill is aimed at "transaction(s)...effecting or...defending against a change in control...." Although the stated purpose of the bill suggests concern over defensive tactics, the actual language suggests that it also applies to bidders. Tender offers as well as defenses could be delayed by injunction until corporate management proves its case in district court--and wins its appeals. Moreover, this would be a powerful, disruptive tool in the hands of dissident shareholders because the reversal of the normal burden of proof would provide a ready means for shareholders to seek to delay routine corporate actions with which they may disagree.

- The bill provides no definition of what constitutes a "defensive tactic." Many legitimate business activities could make a takeover bid more difficult or expensive for the bidder. Must all of these be litigated? Delays generally work against a bidder as the market changes, as more time is available for defensive maneuvers, and as the cost of maintaining its bid increases.

- Transactions "<u>in contemplation</u> of effecting or defending..." <u>are included.</u> If it is difficult to determine whether a transaction is in fact defensive, it must be still more difficult to determine whether a transaction undertaken without the presence of a takeover bid was done "in contemplation" of such a bid.

- What constitutes a "change in control"? In other regulatory contexts, this concept has proved difficult to define and administer. A bid for 51% of the shares is clear, but effective control of most large, public corporations can be gained with far less than 50% of the voting shares. Moreover, the amount needed for effective control varies widely from company to company.

The opportunities for abuse of these provisions are extensive. Potential bidders could sue to prevent a target from taking any management action which might make the target more expensive or difficult to acquire at some future time. Target managements could engage in a series of defensive transactions with the express purpose of forcing litigation during a tender offer, with the reasonable expectation that such litigation will cause delays in the tender offer closing period until the litigation is settled. Dissident shareholders would be given an extraordinarily powerful tool with which to harass managers. The vague, open-ended standards, coupled with the attorney's fee provision, would encourage litigation.

The likely result of H.R. 5695 would be a dramatic increase in litigation and decrease in takeover activity. The people who would benefit the most would be lawyers; shareholders of both targets and bidders would pay the bills.

H.R. 5696--SHAREHOLDERS COMMUNICATION ACT OF 1984

This bill proposes to treat banks, associations, and other entities that exercise fiduciary powers in the same manner as broker-dealers under Section 14(b) of the Securities Exchange Act of 1934. We do not object to the provisions of this bill as proposed.

Sincerely,

Christopher DeMuth
Administrator for Information
and Regulatory Affairs

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20250

JUN 19 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: JOHN R. BLOCK JRB

SUBJECT: U.S. Agricultural Commodity Outlook

U.S. agriculture is presently undergoing a period of transition. Crop prices rose last summer in response to lower output resulting from a record amount of acreage taken out of production due to the PIK program and the worst drought in 50 years. Farmers have responded to higher prices, and significant crop production increases are expected in 1984. While production increases will be large, the overall rise in crop supplies will be dampened by dramatically lower levels of stocks--particularly for corn, soybeans, and cotton--going into the new year. Supplies of most fruits and vegetables will be ample, boosted by larger 1984 crops; 1983 citrus tree damage is uncertain, however. Trade in agricultural products will benefit from global economic growth, but U.S. exports will continue to be dampened by the strong dollar and expanded foreign production. On balance, crop prices are expected to be lower by summer. In contrast, higher livestock prices are estimated as meat production falls below record 1983 levels.

U.S. Commodities: Percent Change From Year Ago

Commodity	Production	Supply	Exports	Prices 1/
Crops	- - - Marketing Year 1984/85 - - -			
Total grains	+51	+8	0	---
Wheat	+4	-1	-5	-4
Rice	+50	+13	0	-2
Corn (and other feed grains)	+73	+12	+3	-14
Soybeans	+32	+11	+10	-11
Cotton	+48	-8	-21	+6
Animal Products	- - - Calendar Year 1984 - - -			
Total meat	-2	-1	-3	---
Beef	-1	-1	+7	+7
Pork	-6	-4	-4	+12
Broilers	+3	+3	-8	+17
	- - - Marketing Year 1983/84 - - -			
Milk	-2	-1	0	-2

1/ Specific price forecasts have not been published for 1984/85.

CM #478

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

June 20, 1984

MEMORANDUM FOR CABINET COUNCIL FOR ECONOMIC AFFAIRS

FROM: THOMAS J. HEALEY T

SUBJECT: Adjustable Rate Mortgage Default Risk

Issue

There has been considerable attention paid recently to the possibility of future significant foreclosures on adjustable rate mortgages (ARMs). This is an important issue because lenders and mortgage bankers are issuing an increasing number of ARMs. Industry sources estimate that over 60% of all new mortgages are adjustable rate. By year-end the U.S. League predicts that $175 billion of ARMs will be outstanding. This paper attempts to briefly overview the issues involved.

Summary of Findings

Although it is too early to predict the exact amount of foreclosures for ARMs, it is likely that default rates on ARMs will be higher than for fixed-rate mortgages if interest rates rise. The distinction between default and foreclosure rates is important because experience indicates that defaults are usually cured through forebearance or other servicing techniques before they result in foreclosures. However, if ARM defaults start to rise at a rate significantly higher than conventional mortgage defaults, then considerable political pressure would be expected from the affected housing and banking industries, and the secondary mortgage markets as well as from the borrowers. As an indication of mounting political pressures the Subcommittee on Housing and Community Development of the House Committee on Banking, Finance and Urban Affairs has already scheduled hearings on June 21 and 26 to address the issue of low initial interest rates.

At this point financial institutions regulatory activity has been minimal, although some regulators have threatened reregulation if the industry does not self-regulate. Attention has concentrated on perceived consumer misunderstanding of ARMs and misleading advertising. For example, both the Federal Reserve Board and the Federal Home Loan Bank Board have issued guidelines concerning the disclosure of effective interest costs to borrowers.

The secondary market purchasers and insurers have begun to respond to the credit risk problem by requiring tighter guidelines. It is expected that their actions will convince many lenders to more carefully assess the risk of default.

There appears to be no need for action, except monitoring the situation, by the CCEA or the Administration at this time. Monitoring is warranted, especially as better data becomes available.

The Problem

It is feared that as interest rates rise people will no longer be able to meet their mortgage payments because many mortgage lenders have allegedly qualified borrowers at low initial interest rates and have ignored (at least temporarily) whether borrowers will be able to make payments if rates rise. As a result the borrowers face potentially large increases in payments after the first year or two, which they may not be able to make.

Borrowers will not be the only ones who suffer if they cannot make their mortgage payments. Thrift institutions, many of whom are already in financial difficulty, are the primary holders of ARMs. In effect, these institutions may have traded the interest rate risk problem for a credit risk problem. ARMs were created as an attempt to cure the severe maturity and interest rate mismatch between long-term assets (mortgages) and short-term liabilities (deposits, etc.) which crippled the thrift industry in the 1970's and early 1980's. It would be unfortunate if the intense competition to issue ARMs to solve the interest rate gap problem leads to significant credit risk problems.

The credit risk problem is aggravated by the recent trend to initial deep discount (or "teaser") mortgages and "buy-down" mortgages which offer initial below market rates usually followed by automatic increases over and above any changes in market interest rates. A deep discount or "teaser" mortgage lender offers a low interest rate up front with the intention of making its profit (assuming no defaults) in later years. A "buy-down" mortgage occurs when a builder or developer pays cash up front to reduce the initial interest rate payments for the borrower. Some of the most significant buy-downs have occurred in depressed real estate markets like Houston, where builders have offered initial rates as low as 4-7/8% to encourage purchases.

These initial discounts further increase the later "payment shock" to borrowers and the risk of default, especially if the borrower were qualified at the low initial rate. The increasing prevalence of these discounts is reflected in Table I, which shows the dropping initial rates on ARMs, even as U.S. Treasury Securities' yields rise. A portion of the decrease in ARM rates is probably due to the increasing proportion of 1-year ARMs relative to 5-year ARMs. 1/ However, at least some of the initial ARM rates offered are below rates for comparable U.S. Treasury securities.

A "buy-down" presents an additional default risk when the market value of the house without the cheap financing is effectively less than the purchase price. The same problem is also created by capping the borrowers' mortgage payments in combination with adding the deferred interest above the cap to the principal portion of the loan (negative amortization). In extreme cases a borrower could conceivably end up with a mortgage greater than the value of the house, resulting in an economic incentive to default. Housing appreciation would alleviate this problem.

It is difficult to assess the extent of the credit risk problem. 2/ Initial data on delinquency rates is unreliable because of the lack of ARM data over a significant time period and the lack of comparable data due to a plethora of ARM types. Industry experts have estimated as many as 300-400 types of ARMs.

Market Reaction

The market initially failed to properly assess the credit rate risk problems associated with borrower qualification procedures based only on first year payments. Only the late 1983 advent of below-market initial ARM interest rates, which exacerbated the credit risk problem, and rising interest rates have caused the market to address the problem.

1/ Within the last 9 months the proportion of 1-year ARMs has apparently risen significantly due to rising interest rates and the steep yield curve. Unpublished estimates range as high as 75% of all new ARMs now have 1-year payment adjustments compared to 36% and 45% in previous years.

2/ Preliminary data from private insurers indicate delinquency rates 25-45% higher for ARMs relative to fixed-rate mortgages. Delinquency rates are usually precursors of default rates. Fannie Mae and Freddie Mac have not issued statistics publicly on ARM delinquency rates.

TABLE I

Comparison of Closing Interest Rates
on
Mortgages vs. U.S. Treasury Securities
July 1982 - May 1984

Date		Effective Average Closing Rate on Adjustable Rate Mortgages */**	U.S. Treasury Securities Average Monthly Bid Yields at Constant Maturities			Effective Average Closing Rate on Fixed-Rate Mortgages
			1-year	5-year	30-year	
1982	July	15.69%	13.24%	14.07%	13.55%	15.53%
	August	15.76	11.43	13.00	12.77	15.55
	September	15.23	10.85	12.25	12.07	15.19
	October	14.63	9.32	10.80	11.17	14.97
	November	14.12	9.16	10.38	10.54	14.20
	December	13.80	8.91	10.22	10.54	13.98
1983	January	13.52	8.62	10.03	10.63	13.54
	February	13.02	8.92	10.26	10.88	13.47
	March	12.91	9.04	10.08	10.63	13.29
	April	12.68	8.98	10.02	10.48	12.82
	May	12.48	8.90	10.03	10.53	12.92
	June	12.27	9.66	10.63	10.93	12.79
	July	12.08	10.20	11.21	11.40	12.80
	August	12.18	10.53	11.63	11.82	12.89
	September	12.41	10.61	11.43	11.63	13.13
	October	12.26	9.81	11.28	11.58	12.94
	November	12.19	9.94	11.41	11.75	12.97
	December	11.97	10.11	11.54	11.88	13.00
1984	January	11.80	9.90	11.37	11.75	12.82
	February	11.74	10.04	11.54	11.95	12.85
	March	11.75	10.59	12.02	12.38	12.82
	April	11.52	10.90	12.37	12.65	12.91
	May	11.65	11.66	13.17	13.43	12.96

Source: Federal Home Loan Bank Board News and U.S. Treasury Department.

*/ The proportion of 1-year ARMs issued relative to 5-year ARMs has been rising recently, which may account in part for the falling rates.

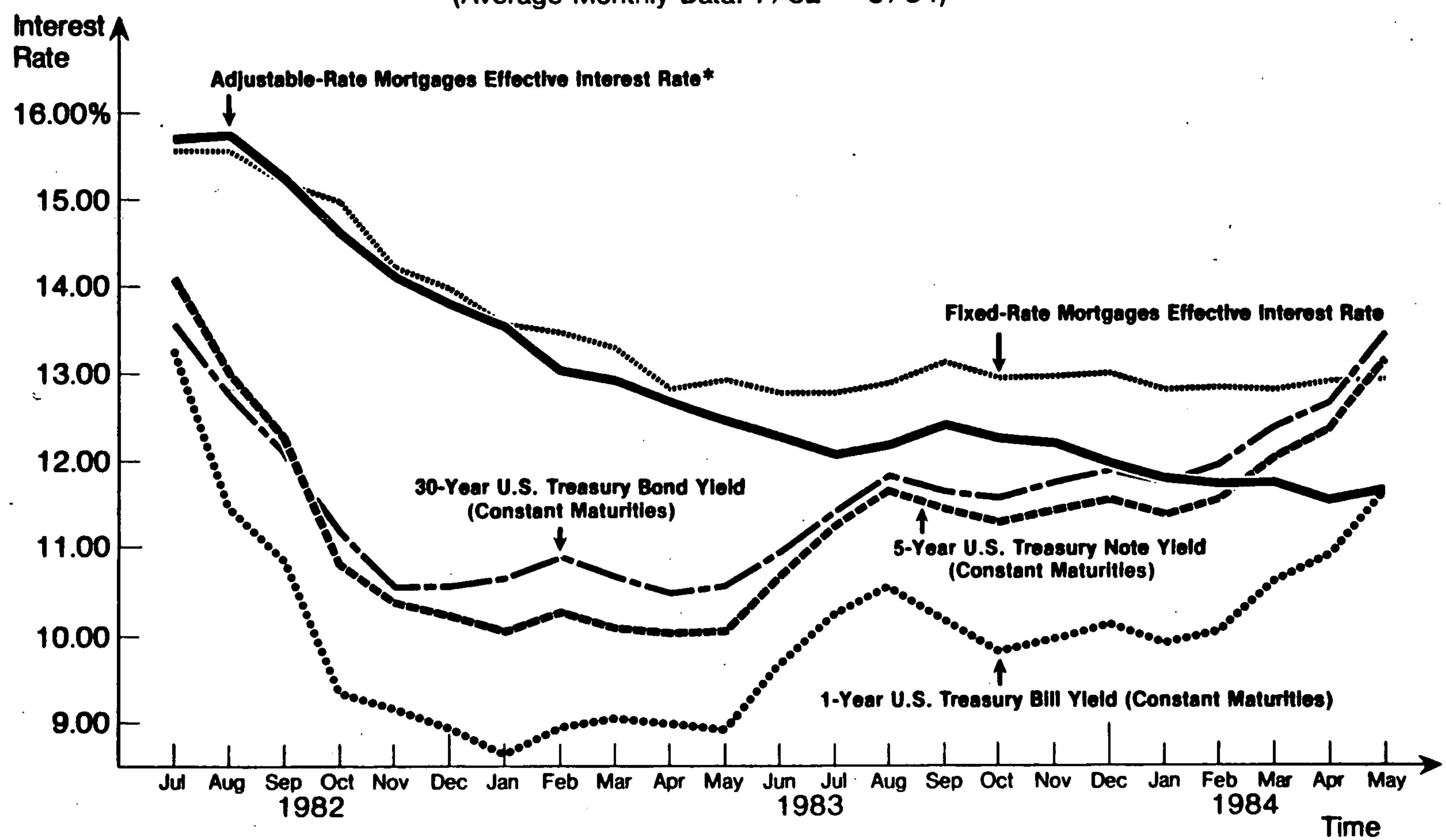
**/ Adjusted for initial fees and charges.

Approved For Release 2008/11/05 : CIA-RDP86M00886R001900200019-3

GRAPH OF TABLE I

COMPARISON OF CLOSING INTEREST RATES ON ADJUSTABLE AND FIXED-RATE MORTGAGES VERSUS U.S. TREASURY SECURITIES

(Average Monthly Data: 7/82 — 5/84)



* The proportion of 1-year ARM's relative to 5-year ARM's has been rising recently, which may account in part for the falling rates.

Source: Federal Home Loan Bank Board News and U.S. Treasury Department.

Approved For Release 2008/11/05 : CIA-RDP86M00886R001900200019-3

Currently all the major secondary market purchasers and insurers are writing stricter ARM guidelines to limit the risk of defaults by borrowers. Within the past six months they have created or are currently reviewing limitations on: (1) interest rate adjustments per adjustment period and over the life of the loan, (2) payment adjustments, (3) the increase in the principal owed due to deferred interest ("negative amortization"), (4) the initial discount rate offered relative to the market rate, (5) buy-downs and (6) borrowers' payments relative to their respective income levels.

For example, Mortgage Guaranty Insurance Corporation ("MGIC"), the largest of the 13 U.S. private mortgage insurers, tightened its requirements in January and February 1984. 1/ Table II lists the current or proposed guidelines issued by Federal Home Loan Mortgage Corporation ("Freddie Mac"), Federal National Mortgage Assocation ("Fannie Mae"), and Government National Mortgage Association ("Ginnie Mae").

There is also some evidence that the use of interest rate or payment caps is rising among primary lenders. Caps reduce the effectiveness of the interest hedge, but they also reduce the credit risk by limiting payment shock to borrowers. According to Fannie Mae and Freddie Mac surveys in January 1982 and August 1983, respectively, the percentage of ARMs with interest rate caps has risen from 33% to 36% and the percentage of ARMs with payment caps has risen from 25% to 32% between the surveys. This brings the percentage of ARMs offering either rate or payment caps to 55% as of August 1983.

1/ MGIC will no longer insure 1-year ARMs if the initial discount is greater than 300 basis points. If there is an initial discount, then MGIC also requires either a 15% payment cap over the life of the 1-year ARM or a 2% interest rate cap per year. For 3-year and 5-year ARMs the initial discount cannot exceed 400 basis points with a further limitation on discount ARMs of either a 100 basis point interest rate cap per year or a 7-1/2% payment cap over the life of the loan. MGIC also requires stricter payment-to-income and debt-to-income ratios of 28% and 36% for ARMs, respectively, compared to 33% and 38% for fixed-rate mortgages, respectively.

TABLE II

Comparison of Mortgage Purchase Requirements

	Fannie Mae */	Freddie Mac **/	Ginnie Mae ***/
	Standard Plan 3/30/84	Standard Plan for Payment Capped ARMs First available 2-1-84	Interim proposal by HUD and GNMA, June 6, 1984
INTEREST RATE CAPS:			
Below Market Discount on Initial Interest Rate	250 b.p. - 1 year 275 b.p. - 3 year 300 b.p. - 5 year	100 b.p.	No formal guideline ****/
Per Adjustment	None	None	100 b.p.
Over the Life of the Mortgage	None	None	500 b.p.
MORTGAGE PAYMENT CAPS:			
Per Adjustment (Optional to borrower)	7.5%	7.5%	None
Limitation on Negative Amortization Relative to Original Loan Value	25%	25%	Precluded by above rules
MONTHLY PAYMENTS RELATIVE TO MONTHLY INCOME:			
Housing Payments/Gross Income (including taxes and insurance)	28%	25-28%	38% (Housing payments include maintenance/after-tax income)
Debt Payments/Gross Income	36%	33-36%	53% (Same ratio as above)
OTHER TERMS:			
Adjustment Periods Allowed	1-3-5 years	1-3-5 years	1 year
Index Security	US Treasury Securities	US Treasury Securities	US Treasury Securities
Loan-to-Value Ratio	At most 95% for owner occupied principal residence but require insurance if less than 20% deposit.	Same as Fannie Mae	97% of first $25,000 of appraised value: 95% of remainder for owner occupied residence

b.p. - basis points

*/ Fannie Mae has other plans available. It is currently testing some plans with interest rate caps of 2% percentage points per adjustment and 5% percentage points over the life of the loan. Fannie Mae also limits the buy-down amount to 6% of the lesser of sales price or appraised value for a loan-to-value ratio greater than or equal to 90% and 10% for a loan-to-value ratio of less than 90%.

**/ Freddie Mac also issues uncapped ARMs for 3- and 5-year ARMs. Freddie Mac is in the process of reviewing interest rate caps and whether it should make payment/income ratios stricter for ARMs than conventional mortgages. Freddie Mac disallows buy-downs of 1-year ARMs and limits other buy-downs to 10% of the original loan amount.

***/ FHA sets the mortgage standards for Ginnie Mae securities. Its underwriting standards are based on the true first-year payment, ignoring any buy-downs.

****/ Effectively disallowed because Ginnie Mae sets the interest rate for the pool of mortgages and will not accept mortgages below that rate.

EXECUTIVE SECRETARIAT
ROUTING SLIP

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI				
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA				
7	DDO				
8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/Pers				
14	D/OLL				
15	D/PAO				
16	SA/IA				
17	AO/DCI				
18	C/IPD/OIS				
19	N10/ECON		✓		
20					
21					
22					

SUSPENSE ____________________
Date

Remarks

FYI only

STAT

Executive Secretary

6/20/84
Date

3637 (10-81)

THE WHITE HOUSE
WASHINGTON

Executive Registry
84-2663

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 6/19/84 **Number:** 169013CA **Due By:**

Subject: Cabinet Council on Economic Affairs - June 21, 1984
8:45 a.m. - Roosevelt Room TOPIC: Financial Market Developments

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
Baker	☑	☐
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
~~Jenkins~~ Chapman	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, June 21, 1984, at 8:45 a.m. in the Roosevelt Room.

The agenda and background paper are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson
☑ Tom Gibson
☐ Don Clarey
☐ Larry Herbolsheimer
Associate Director
Office of Cabinet Affairs
456-2800

DCI
EXEC
REG

L-3008

THE WHITE HOUSE

WASHINGTON

June 19, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the June 21 Meeting

The agenda and papers for the June 21 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider the report of the Working Group on Financial Market Developments. The members of the Working Group have prepared three papers. The first, from William Poole, deals with "Interest Rates, Stock Prices, and Monetary Policy." The first section of his paper describes what has happened in the financial markets thus far in 1984 in the context of longer-term trends in these markets. He includes a discussion of the role of expectations and has a concluding section with some general comments on monetary policy and on the outlook for the securities markets over the second half of 1984.

The second paper, prepared by Gregory Ballentine, deals with "Money and Inflation." It focuses on the unreliability of the short-term money data and examines the long-term relationship between money and inflation.

The third paper, by Beryl Sprinkel, concentrates on "Recent Monetary Policy" and examines the economic implications of recent developments in monetary policy.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

June 21, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments (CM # 111)